

Accountability Requirements for Sub-Entities of Local Authorities

June 2001

This is a copy of the letter sent to all local authority CEOs, Auditors, SOLGM, Department of Internal Affairs and Local Government New Zealand accompanying the Report that follows.

8 June 2001

ACCOUNTABILITY REQUIREMENTS FOR SUB-ENTITIES OF LOCAL AUTHORITIES

From 1 July 2001 there will be a number of changes to the accountability arrangements for the sub-entities that Councils control. These will stem from the Public Audit Act 2001, the expected revised Accounting Standard on Consolidation (to be based on ED84) and also the flow-on from the changes to the LATE definition that occurred last year.

It is important that local authorities adopt a consistent approach. We have written the attached paper to assist auditors and authorities to respond to the changed environment.

We appreciate that the paper is quite detailed but feel it is important that we set out the logic behind the approach we are recommending. We expect our auditors to work the implications through with Councils to ascertain exactly what impact the changes will have for each Council.

For some Councils, with relatively few sub-entities, the impact will be minimal. At the same time, we are aware that some Councils will have a significant number of sub-entities that may be affected by the new accountability arrangements. The implementation of the Public Audit Act from 1 July 2001 will require contact to be maintained with those responsible for sub-entities. It is important that both the audit and the accountability relationships are established early so that there are no delays when reporting in 2002.

If you or your staff have any issues with the paper we recommend that they discuss them initially with the auditor. Our auditors have been asked to ensure that we are kept apprised of any problems that surface as a result of the changes and we will provide additional advice on a sector-wide basis if necessary.

Yours sincerely

Kevin Brady
Deputy Auditor-General

ACCOUNTABILITY REQUIREMENTS FOR SUB-ENTITIES OF LOCAL AUTHORITIES

Issues

There is scope for uncertainty in determining accountability requirements for sub-entities in the local government sector. The uncertainty arises from the amended definition of local authority trading enterprise (“LATE”) and an apparent conflict between reporting requirements in the Local Government Act 1974 (“LGA”) and generally accepted accounting practice (“GAAP”).

The recently enacted Public Audit Act 2001 does not impact on those areas but assists in determining audit arrangements for local government sub-entities.

Purpose of paper

In this paper the Office of the Controller and Auditor-General provides auditors and local authorities with guidance on these issues.

This paper is in three parts and discusses:

- the amended definition of LATE;
- local authority financial statements and GAAP; and
- the definition of “public entity” under the Public Audit Act.

Executive summary

Amended definition of LATE

The definition of LATE in the LGA was amended in 1999 in order to exclude non-profit, non-company organisations under council control. This followed amendments to the Income Tax Act 1994 preventing LATEs from applying for charitable status for tax purposes or for exemption from income tax for organisations involved in district improvement.

The new definition is intended to exclude:

- non-profit trading organisations that are council controlled; and
- profit-oriented trading undertakings where one or more councils have less than 50% of voting rights or the right to appoint less than half of the directors.

The Select Committee that considered the new definition was confident that the “business test” (from case law in the tax area) is sufficiently robust to distinguish correctly between:

- charitable organisations that make a profit only to reinvest it in the organisation; and
- profit-making trading organisations that are not intended to be exempt from taxation.

In this paper we discuss the amended definition of LATE as it applies to companies and to non-company “organisations”. The amended definition is much clearer than the previous definition. However, there is still scope for differing interpretations, especially concerning:

- the circumstances in which an entity is indirectly controlled by a local authority, particularly where a trust is involved in the ownership chain; and
- whether an entity has the intention or purpose of making a profit.

Inconsistency between reporting requirements in the LGA and GAAP

In the second part of this paper we outline an apparent inconsistency between the LGA and GAAP regarding the information that must be included in the consolidated financial statements of a local authority.

We summarise what local authorities must include in annual plans and annual reports about sub-entities, and the requirements of GAAP for consolidation of such entities.

The paper suggests that there appear to be two areas of conflict between the LGA and GAAP:

- the requirement in the LGA to consolidate *any* LATE in which a local authority holds shares or has a financial interest; and
- the requirement in the LGA to consolidate any trading enterprise, company or organisation in which the local authority has a significant interest.

Our view is that it would be preferable for the inconsistency to be addressed by amending the LGA.

Public Audit Act

In part three of the paper we outline the impact of the Audit Office’s new legislation – the Public Audit Act – on sub-entities in the local government sector.

The definition of “public entity” in the Public Audit Act includes any local authority and any LATE, as well as any entity controlled by one or more other public entities. The paper discusses the three limbs of the test for “control” in the Public Audit Act, and notes that it will make the Auditor-General the auditor of a wider range of entities in the local government sector.

Part 1

The Definition of LATE

101 The definition of LATE in the LGA was amended by the Local Government Amendment Act 1999 in order to exclude non-commercial, non-company organisations. This followed amendments to the Income Tax Act 1994 preventing LATEs from applying for charitable status for tax purposes or for the income exemption available for organisations involved in city or district improvement.

102 The new definition is intended to exclude:

- non-profit trading organisations that are council controlled; and
- profit-oriented trading undertakings where councils have less than 50% of voting rights or the right to appoint less than half of the directors.

103 A definition of LATE was inserted into the Income Tax Act 1994 at the same time.¹ That definition is wider than the definition of LATE under the LGA. The tax definition includes an entity controlled by a council that is not a LATE but that has control of a LATE. This is to prevent a local authority avoiding paying tax on income derived from a LATE (via a non-LATE).

The amended definition in the LGA

104 “LATE”, as amended (with effect from 1 April 1999), means:²

- (i) *a company in which equity securities carrying 50% or more of the voting rights at a meeting of the shareholders of the company are—*
 - (A) *held by 1 or more local authorities; or*
 - (B) *controlled, directly or indirectly, by 1 or more local authorities; or*
- (ii) *an organisation that—*
 - (A) *operates a trading undertaking with the intention or purpose of making a profit; and*

¹ The Income Tax Act definition applying from the 1999/2000 income year includes:

- (a) a LATE (as defined in the LGA); and
- (b) an organisation (as defined in s 594B(2) of the LGA) that—
 - (i) is subject to significant control (as defined in section 594B(2) of that Act), directly or indirectly, by 1 or more local authorities; and
 - (ii) has significant control (as so defined), directly or indirectly, of a local authority trading enterprise within the meaning of paragraph (a).

² s 594B(1)(a) LGA.

(B) *is subject to significant control, directly or indirectly, by 1 or more local authorities.*

105 Certain entities are excluded from the definition:³

- port companies and their subsidiaries;
- energy companies and energy supply operations; and
- the New Zealand Local Government Association Limited and any company or organisation directly or indirectly controlled by the Association.

106 Airport companies within the meaning of the Airport Authorities Act 1966 were excluded from the definition prior to 1 July 2000.⁴

Analysis of the definition

107 For the purpose of analysis, we deal separately with those LATEs that are companies, and those that fall within the definition of “organisation”.

A LATE that is a company

108 A company does not have to be a trading undertaking, or intend to make a profit, to be a LATE. The test for whether a company is a LATE depends on the extent of local authority ownership (limb (i)(A)) or control (limb (i)(B)). The nature of the company’s activities is not relevant.

The two limbs of the test

109 Section 594B(1)(a)(i) has two limbs. The first we describe as the “ownership” limb. It refers to:

(i) *a company in which equity securities carrying 50% or more of the voting rights at a meeting of the shareholders of the company are—*

(A) *held by 1 or more local authorities.*

110 Under the ownership limb, the focus is solely on the extent of direct local authority **ownership** of voting shares. Any company in which a local authority or local authorities⁵ own shares carrying 50% or more of the voting rights (“voting shares”) is a LATE.⁶

³ s 594B(1)(b) LGA.

⁴ See clause 2 Local Government Amendment Act (No 5) 1996 Commencement Order 1999 (SR 1999/276).

⁵ For the rest of this part of the paper, we use the singular term “local authority” to cover both situations.

⁶ Note, by contrast, that the test for “subsidiary” in the Companies Act 1993 requires the shareholder to hold *more than 50%* of shares or voting rights or to have the right to appoint or remove a majority of directors of the board. See the Appendix to this paper which sets out s 5 and s 7 of the Companies Act 1993.

- 111 The second limb we describe as the “control” limb. It refers to:
- (i) *a company in which equity securities carrying 50% or more of the voting rights at a meeting of the shareholders of the company are—*
- (B) *controlled, directly or indirectly, by 1 or more local authorities.***
- 112 Under the control limb, the focus is on whether the local authority has direct or indirect **control** of 50% or more voting shares.
- 113 The LGA does not define “control”. The relevant dictionary definition of “control” relates to the power to direct or command. In the context of relationships between corporate bodies, “control” generally means that an entity holds sufficient shares or voting power to regulate or direct the activities of another entity.⁷
- 114 Control under the LGA may also be direct or indirect. A local authority will have direct control of shares if it holds the shares itself. The “ownership” and “control” limbs of the definition overlap in this respect.
- 115 But the circumstances in which a local authority has indirect control of voting rights are less clear. We now discuss that question in more detail.

Indirect control

- 116 The concept of indirect control was first introduced into the definition of LATE in 1992 (by an Income Tax Amendment Act). At that time a LATE included:
- any other company or organisation (being an organisation through which a trading undertaking is operated) which a local authority or local authorities, directly or indirectly, have control of by any means whatsoever.* (underlining added)
- 117 The aim of this amendment was to ensure that the definition covered subsidiaries of LATEs. But the wide scope of the words “control by any means whatsoever” caused interpretation problems.
- 118 The concept of *indirect control* has been retained in the amended definition. The problematic words “by any means whatsoever” have been omitted. However, the definition continues to cause uncertainty for second and lower tier companies.
- 119 The issue is reasonably straightforward where a nominee holds shares on a local authority’s behalf. In that case, the shares can be seen as being indirectly controlled by that local authority. However, where shares in a company are held by a subsidiary of a local authority, can the local authority indirectly control those shares through its control of the subsidiary?

⁷ Again, this usually requires a shareholder to hold *more than 50%* of shares or voting rights.

120 There are two possible approaches to this question:

- control as a matter of law; and
- control as a matter of fact.

121 We describe each in turn, and then consider which of the two approaches is preferable when considering the definition of “LATE” under the LGA.

Legal control

122 Determining “legal control” requires analysing relationships between entities based on ownership of voting shares. Under this approach the enquiry is:

- Does the local authority control the company’s parent company?
- Does the parent company control 50% or more voting shares of the second tier company?

123 If the answer to both questions is yes, the local authority indirectly controls 50% or more voting shares of the second tier company (through its direct control of the parent company and the parent company’s direct control of the second tier company).

124 In the case of a group of companies with multiple tiers, a lower-tier company could be a LATE under this approach if there is sufficient indirect “control”.

125 The meaning of legal “control” or “controlling interest” is illustrated by a number of tax cases.

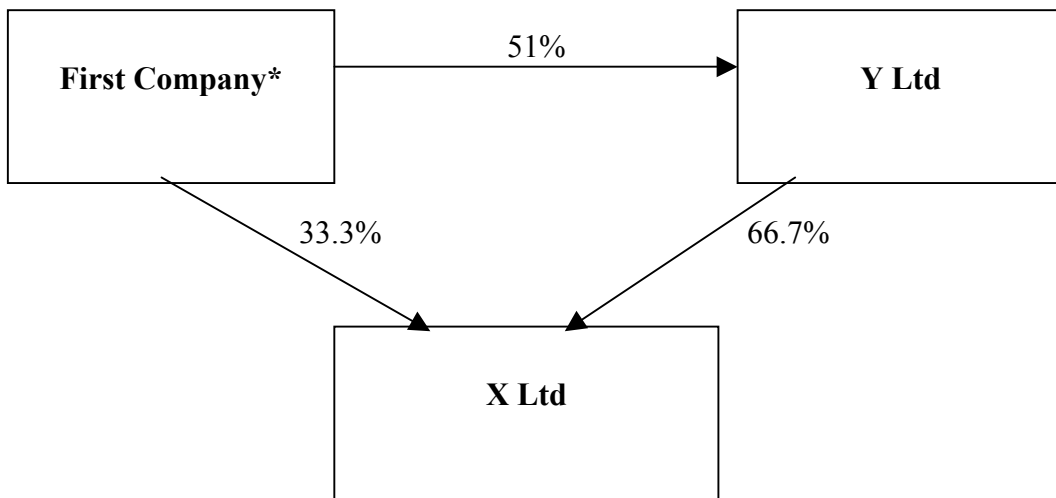
126 In *British-American Tobacco Co Ltd v Commissioners of Inland Revenue* [1943] AC 335, the House of Lords considered whether a United Kingdom company had a “controlling interest” in 11 companies carrying on business outside the UK. In some cases, more than 50% of the shares were owned by the UK company and a subsidiary of that company (including where 100% of the shares of the overseas company were owned in this way). The House of Lords confirmed the findings of the lower courts that a “controlling interest”, in the context of the tax statute being considered, included an interest of over 50% made up of direct and indirect shareholdings. It noted that:

... the concept of “controlling interest” may well cover the relationship of one company towards another, the requisite majority of whose shares are, as regards their voting power, subject, whether directly or indirectly, to the will and ordering of the first mentioned company. If, for example, [a company] owns one-third of the shares in Company X, and the remaining two thirds are owned by Company Y, the [first mentioned company] will nonetheless have a controlling interest in Company X if it owns enough shares in Company Y to control the latter.

127 The Court did not consider whether the UK company could *in fact* control voting at meetings of shareholders of the overseas companies, but decided it had a “controlling interest” in each, based on its direct and indirect ownership of shares.

128 Figure 1 illustrates this approach.

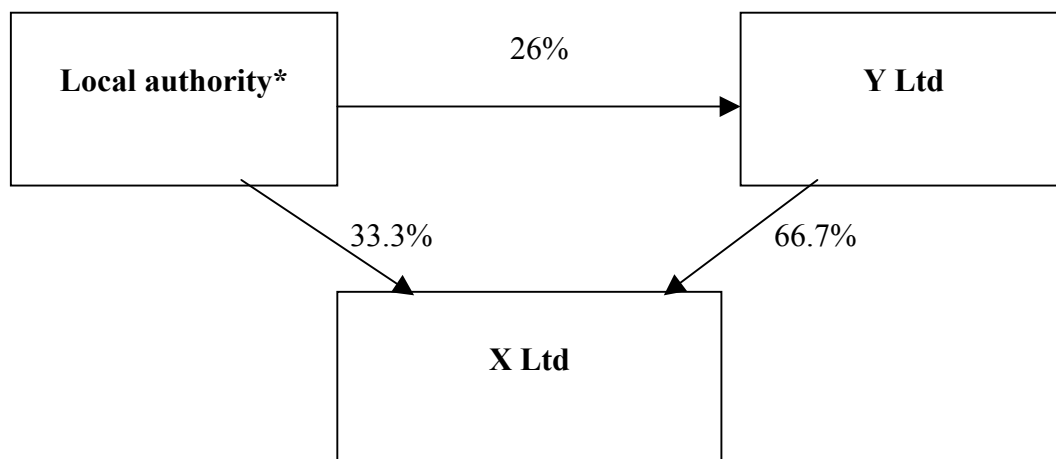
Figure 1



*First company controls just over two thirds of the shares in X Ltd, based on its direct and indirect ownership of shares: $33.3 + 34$ (being 51% of 66.7) = 67.3% .

129 Figure 2 illustrates this approach as it applies in the definition of LATE.

Figure 2



- *Local Authority will directly or indirectly control 50% or more shares in X Ltd if it has 26% or more shares in Y Ltd.
- The local authority's "control" over X Ltd is calculated by adding its direct and indirect shareholdings as follows: $33.3 + 17.34$ (being 26% of 66.7) = 50.62%.
- This is solely based on the local authority's shares in X Ltd and Y Ltd and would be subject to the constitutions of Y Ltd and X Ltd as to the exercise of voting rights.

130 It can be seen that legal control can be determined by examining the ownership relationships among the companies in a group.

Factual control

131 Under this approach, the enquiry is:

Can the local authority *as a matter of fact* directly or indirectly control 50% or more of the votes at a meeting of shareholders of the second tier company?⁸

132 An illustration of factual control, as distinguished from legal control, is where a group of shareholders whose combined shareholding totals more than 50% agree to vote together. While none of those shareholders has control in their own right, they have agreed to act together and so control the company as a matter of fact.

133 The need to consider factual, as well as legal, control depends on the legislative context. For income tax purposes, it is relevant to determine who exercises control

⁸ Where shares are held by a body corporate, the body corporate may appoint representatives to exercise its voting power in the same way as a shareholder may appoint a proxy (Companies Act 1993, First Schedule, clause 10). The constitution could require shareholder representatives to consult with the local authority before voting occurs. In that case the local authority would indirectly control the shares of the second tier company.

over the business or day to day operations of a company and in which country that control is exercised. This requires determining control as a matter of fact.

- 134 In the Australian case *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Limited* [1980] 80 ATC 4371, the Court held that, in the context of the tax legislation being considered, “control” meant actual control of the business of the company, and not the capacity to control a meeting of shareholders based on share ownership. The issue in that case was whether a company’s business was “controlled” principally by non-resident shareholders or by resident directors of the board. A factual enquiry was therefore required.
- 135 In a contrasting case, *Case K54* (1988) 10 NZTC 444, the New Zealand Taxation Review Authority considered the meaning of “control” in s 55 of the Goods and Services Tax Act. Under that section, two or more companies or other registered persons are eligible to be members of a group for registration for GST purposes. In the case of a group of companies the “control” relationship among the companies is relevant. The Income Tax Act 1976 applying at the time defined “control” in the traditional legal sense (more than 50% of shares or votes or entitlement to more than 50% of profits, etc). The Authority noted that, while in some cases it is appropriate to consider whether “control” exists as a question of fact where legal control is unclear, this was not appropriate in a tax Act, particularly as factual control could easily change from time to time

The approach required under the LGA

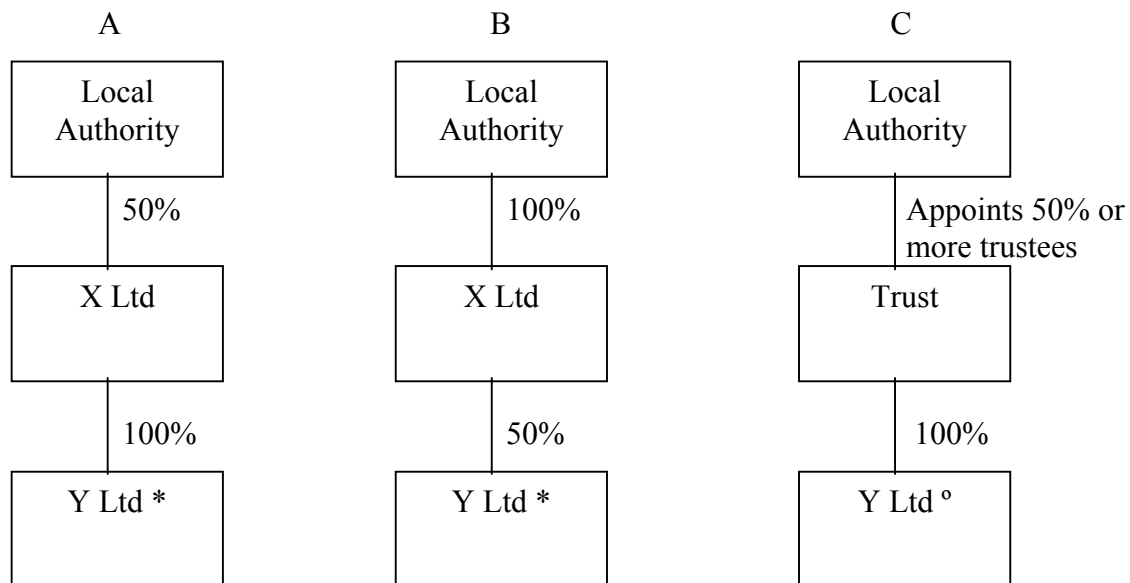
- 136 Where a local authority has a holding company and the holding company owns shares in another company, that company will be a LATE only if the local authority indirectly controls 50% or more of its voting shares.
- 137 If *legal* control is sufficient, the company will be a LATE if the local authority indirectly owns 50% or more shares of the company. Control (or capacity to control) could be *presumed* (as a matter of law) to exist, based on that indirect shareholding. The local authority’s indirect control of voting rights in the company could be exercised through its direct control of the holding company, for example, the local authority’s right to remove directors of the holding company.
- 138 If *factual* control is required, the company will be a LATE only if the local authority can direct the holding company as to the exercise of 50% or more of voting rights in the second tier company, as well as having indirect control in the legal sense.
- 139 The purpose of the enquiry under the LGA is not to determine whether the local authority has control of the day to day *business* of the company, but whether the local authority directly or indirectly controls 50% or more voting shares. This suggests that, as a rule, it is not necessary to establish factual control if the legal relationships between the relevant companies are clear.
- 140 We therefore think that a company in which 50% or more of the voting shares are owned by a company, which is in turn 100% owned by a local authority, will be

indirectly controlled by the local authority, regardless of whether the local authority in fact (indirectly) controls voting at meetings of shareholders of the company (see columns A and B of figure 3 below).

141 However, the test of factual control may be relevant where the extent of legal control is not clear.

142 A particular example that may arise under the LGA is that of a company formed by a trust that is controlled by a local authority. While the local authority may have the power to appoint and remove trustees of the trust, trust law and the trust deed would require those trustees, in exercising voting rights at a meeting of a subsidiary company, to act independently and in accordance with the purposes of the trust. Therefore, the local authority may not *in fact* indirectly control voting rights at a meeting of shareholders of the trust's subsidiary (see column C of figure 3 below).

Figure 3



* In columns A and B, Y Ltd is a LATE, being a company in which 50% of the voting shares are indirectly controlled by a local authority.

° In column C, whether the local authority indirectly controls Y Ltd will depend on whether the local authority has any control of the exercise by trustees of their voting rights at meetings of shareholders.

Summary of conclusions on a LATE that is a company

143 The key conclusions in respect of company LATEs are:

- A company may be a LATE under either the ownership limb or the control limb of section 594B(1)(a)(i).
- Under the ownership limb, the focus is solely on the extent of direct local authority ownership of voting shares.

- Under the control limb, the focus is on whether the local authority has direct or indirect control of 50% or more voting shares.
- Direct control is synonymous with ownership. The ownership and control limbs overlap in this respect.
- In cases where the legal relationships between the local authority and the relevant companies in a group are clear, indirect control can be determined using a legal test, based on ownership of voting shares.
- Where the extent of indirect legal control is not clear (for example, in the case of a company formed by a trust that is controlled by a local authority), a test of factual control may be relevant.

A LATE that is an organisation

144 The definition of LATE includes:

- (ii) *An organisation that—*
- (a) *operates a trading undertaking with the intention or purpose of making a profit; and*
 - (b) *is subject to significant control, directly or indirectly, by 1 or more local authorities.*

145 “Organisation” means:

any partnership, trust, arrangement for the sharing of profits, union of interest, co-operation, joint venture, reciprocal concession or other similar arrangement; but does not include a company or a committee or joint committee of a local authority.

146 “Significant control” means:

(a) control of 50 percent or more of the votes at any meeting of the members or controlling body of the organisation; or
(b) the right to appoint half or more of the trustees, directors, or managers (howsoever described) of the organisation,—
whether or not jointly with other local authorities or persons.

147 Companies, council committees and joint committees are excluded from the definition.

The meaning of “organisation”

148 The definition of “organisation” is very wide. An “organisation” does not have to be a separate legal entity. The definition is wide enough to cover, for example, a one-off joint venture property development between a council and a developer, even though some of the accountability provisions in the LGA do not readily apply to LATEs that are not corporate entities.

149 For example, those provisions assume each LATE will have a “directorate”. This will not necessarily be the case in a profit-sharing contract between a council and another party.

“A trading undertaking with the intention or purpose of making a profit”

150 Whether an organisation operates a trading undertaking is a question of fact. If an entity is involved in buying or selling goods and services, it is likely to be operating a trading undertaking. In tax law, “operating a trading undertaking with the intention or purpose of making a profit” is analogous to running a business.⁹ To be considered a business, an activity must exhibit certain characteristics.

151 In the leading New Zealand case,¹⁰ the Court of Appeal suggested a two-fold inquiry as to whether a taxpayer was conducting a business. The inquiry focuses on, first, the nature of the activities carried out; and secondly, the intention of the taxpayer in engaging in those activities. Factors to consider are:

- the nature of the activity;
- the period over which it is engaged;
- scale of operations and volume of transactions;
- commitment of time, money and effort;
- pattern of activity; and
- financial results (the fact that a business is unprofitable does not mean it is not a business).

152 The Court suggested that it may be helpful to consider whether the operations involved are of the same kind, and are carried on in the same way, as those which are characteristic of ordinary trade in the line of business in which the venture is conducted.

153 We use this approach when considering whether various organisations are LATEs. We have suggested to local authorities that, where the trustees or directors of an organisation operate a trading undertaking but are required to invest any profits in the organisation (rather than distribute them to themselves or shareholders) the organisation may *not* be operating with the intention or purpose of making a profit.

154 This interpretation involves giving “profit” the meaning of a benefit or advantage to some other party (such as a return to a shareholder), rather than the meaning of applying any profit from trading activities for the purposes of the organisation.

155 This fits with our understanding of the income tax exemption available for “non-profit bodies” in the Income Tax Act 1994.¹¹ It also fits with a statement by the

⁹ In the Income Tax Act 1994, the term “business” includes any profession, trade, manufacture or undertaking carried on for pecuniary profit.

¹⁰ *Grieve v Commissioner of Inland Revenue* [1984] 1 NZLR 101, 110.

¹¹ A characteristic of such bodies being that no part of their funds may be used for the private pecuniary profit of any member, shareholder, settlor etc.

Select Committee in its report on the Bill which led to the 1999 amendment of the definition of LATE:¹²

We are confident that the business test is sufficiently robust to distinguish correctly between charitable organisations that make a profit only to reinvest it in the organisation and profit making trading organisations that are not intended to be exempt from taxation.

Summary

- 156 Whether an organisation is “operating a trading undertaking with the intention or purpose of making a profit” at any time will be a question of fact, to be determined using the “business test” from the *Grieve* case noted above.
- 157 Should an entity controlled by a local authority apply for charitable status for tax purposes, the Inland Revenue Department would need to consider whether the entity is a LATE. If an entity is granted non-profit or charitable status for tax purposes, we could have regard to that in considering whether it is a LATE under the LGA.

“Significant control”

- 158 The definition of “significant control” in the Act makes this aspect of the test easy to apply. As with the test for company LATEs, the definition of “significant control” uses a slightly lower threshold (50% or more) than the meaning of “control” used in other legislation such as the Companies Act (more than 50%).
- 159 However, there may be some room for uncertainty in determining whether an organisation is subject to *indirect* “significant control” by a local authority. Where organisations other than companies are involved in the ownership chain, the question of indirect significant control may more readily be determined as a question of fact rather than law.

¹² Internal Affairs and Local Government Committee - Report on the Local Government (Meaning of Local Authority Trading Enterprise) Amendment Bill (No. 246-1).

Summary of conclusions on a LATE that is an organisation

160 The key conclusions on non-company LATEs are:

- The term “organisation” is wide, and is not confined to separate legal entities.
- Whether an organisation is “operating a trading undertaking with the intention or purpose of making a profit” at any time is a question of fact.
- A factual test, rather than a legal test, may more readily determine whether a local authority indirectly exercises “significant control” over an organisation, where non-company organisations are involved in the ownership chain.

Concluding comment on Part 1

161 The amended definition of LATE is much clearer than the previous definition. However, there is still scope for differing interpretations, especially concerning:

- the circumstances in which an entity is indirectly controlled by a local authority, especially where a trust is involved in the ownership chain; and
- whether an entity has the intention or purpose of making a profit.

Part 2

Local Government Act: Accountability requirements and GAAP

- 201 This part of the paper discusses an apparent conflict between GAAP and accountability requirements in the LGA concerning reporting.
- 202 In summary, s 223E(4) of the Act appears to require local authorities to consolidate into their financial statements entities that would not be viewed as “controlled” within the meaning of GAAP.

LGA requirements

Annual Plan

- 203 A local authority must include in its annual plan certain information in respect of the authority, and in respect of each:

- (a) LATE,
- (b) company, and
- (c) other organisation

that is under the *control* of the authority, and in respect of each:

- (d) trading enterprise,
- (e) company; or
- (f) organisation

in which the authority has a *significant interest*.

- 204 The annual plan must include intended significant policies and objectives of the local authority, LATE, company, or other organisation, and the nature and scope of the significant activities to be undertaken.

Annual report

- 205 Section 223E(4) requires a local authority’s annual report to include audited consolidated financial statements for the financial year in respect of—

- (a) the authority;
- (b) each LATE in which the authority holds shares or has a *financial interest*; and
- (c) each other company or organisation that is under the control of the authority or is a trading enterprise, company, or organisation in which the authority has a *significant interest*.

206 Section 223E(5) requires that the audited consolidated financial statements be prepared in accordance with GAAP for inclusion in the annual report.

Comment

207 The information that must be included in the annual report about sub-entities of local authorities corresponds with the annual plan requirements.

208 As noted in Part 1 of this paper, “control” is not defined in the LGA. We think it appropriate to interpret “control” in s 223E(4) by reference to GAAP, given that the consolidated financial statements must be prepared in accordance with GAAP.

209 The reference in s 223E(4) to “a company under the control of the local authority” would include a local authority controlled port or energy company (such companies being excluded from the definition of LATE). The reference in sections 223D(1) and 223E(4) to an “organisation under the control of the local authority” will include organisations that are not LATEs (i.e. non-profit organisations that are not companies).

“Significant interest”

210 “Significant interest” is not defined but it is clear that it is something other than “control”. Local authorities are required to make judgements about “significance” elsewhere in the LGA: for example, s 247E, in relation to tendering contracts involving “significant” expenditure; and s 594O, in relation to the divestment of “significant” undertakings.

211 The fact that s 223E(4) refers to both “financial interest”¹³ (paragraph (b)) and “significant interest” (paragraph (c)) indicates that a significant interest can be other than a financial interest.

212 In interpreting “significant interest”, it is appropriate to consider the purpose of the sections concerning annual plans and annual reports. The purpose of those sections is to provide the public with sufficient information to enable an informed assessment of the operations and activities of local authorities and their LATEs and other sub-entities. Later in this part of the paper, we suggest that it is possible to meet both the public information requirements and the requirements of GAAP.

GAAP requirements

¹³ Where a local authority has a financial interest in, or has otherwise provided finance or financial assistance to any LATE or to any company or organisation controlled by the local authority or in which it has a significant interest, that local authority shall include, in its audited financial statements, a separate statement disclosing the actual costs to the enterprise, company, or organisation concerned of that interest, finance, or financial assistance - s223E(6). The provision of finance or financial assistance includes provision that is direct or indirect and whether by way of share capital, loan guarantee, the giving of security, or otherwise – s 223E(7).

213 For general-purpose financial statements, the circumstances in which entities are consolidated are determined having regard to:

- the particular arrangement in each situation; and
- SSAP-8: *Accounting for Business Combinations* and ED-84: *Consolidating Investments in Subsidiaries*.

214 SSAP-8 is the current accounting standard that deals with, amongst other matters, consolidation of entities. ED-84 is a proposed revision to that part of SSAP-8 that deals with consolidation and is expected to replace that part of SSAP-8, as a Financial Reporting Standard, later in 2001.

SSAP-8

215 SSAP-8 requires a local authority to consolidate its subsidiaries and in-substance subsidiaries. “Subsidiary” is narrowly defined in terms of the Companies Act 1955 (since replaced by the Companies Act 1993), and “in-substance subsidiary” is defined as:

an entity ... which is controlled by another entity.

216 “Control” is a key factor in determining which entities a local authority is required to consolidate.

217 A definition of control is provided in paragraph 3.6 of SSAP-8:

... the power to govern the financial and operating policies of another entity for the purpose of obtaining the benefits and/or assuming the risks normally associated with ownership.

218 The definition requires there to be both a power and a benefit and/or risk when determining whether or not an entity controls another and (hence) should be consolidated.

ED-84

219 ED-84 is broadly similar to SSAP-8 as regards consolidation. ED-84 contains more guidance to help ascertain whether a local authority “controls” another entity. Control is not limited to situations in which a local authority has in excess of a 50% ownership interest in an entity. Control has to be considered having regard to all the circumstances surrounding where the powers and benefits lie.

220 In practice, local authorities may need to change the way they account for some entities with which they have an association if ED-84 becomes a Financial Reporting Standard. There may be changes to the range of entities that must be consolidated into the group. For example, some trusts that are not currently consolidated may need to be.

- 221 Entities that are not controlled by a local authority, but in which the local authority has a financial interest, may have to be accounted for in a manner other than full consolidation. Under GAAP, a local authority that is associated with another entity in a 50/50 arrangement would not consolidate that entity but, instead, may have to account for it as an interest in a joint venture. If the local authority had a significant interest in an entity, but this interest did not give the local authority control (as defined), then GAAP may require the entity to be equity accounted by the local authority.

The relationship between the LGA reporting requirements and GAAP

- 222 Two aspects of the statutory reporting requirements in the LGA appear to conflict with GAAP. They are:
- section 223E(4)(b), which appears to require consolidation of *any* LATE in which a local authority *holds shares* or has a *financial interest*; and
 - section 223E(4)(c), which appears to require consolidation of any trading enterprise, company or organisation in which the local authority *has a significant interest*.
- 223 Both we and the Institute of Chartered Accountants have suggested to the Department of Internal Affairs that it would be preferable for the inconsistency to be addressed by amending the Act. As an interim step, we suggest that local authorities:
- prepare their financial statements in accordance with GAAP; and
 - include information about any entities that are not controlled under GAAP in their financial statements by way of note disclosure (instead of consolidating such entities).
- 224 This would ensure that the requirements of both the LGA and GAAP are met before any amendment to the LGA is made.

Part 3

The Public Audit Act and sub-entities in local government

301 The Public Audit Act comes into force on 1 July 2001. The Act provides that the Auditor-General is the auditor of all “public entities”, and lists “public entities” by class in Schedule 1 or by name in Schedule 2. Local authorities, LATEs, and community trusts established under the LGA are listed in Schedule 1. Specific entities (for example, the Aotea Centre Board of Management and Selwyn Plantation Board Limited) are listed in Schedule 2.

302 The Act also makes the Auditor-General the auditor of all entities that are “controlled” by one or more public entities. Section 5(2) of the Act says:

An entity is controlled by 1 or more other public entities if-

- (a) *it is a subsidiary of any of those other entities; or*
- (b) *the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or*
- (c) *the other entity or entities can together control directly or indirectly the composition of its board within the meaning of sections 7 and 8 of the Companies Act 1993 (to be read with any necessary modifications).*

303 In section 4, “subsidiary” means:

- (a) a subsidiary within the meaning of sections 5 to 8 of the Companies Act 1993 (sections 5 and 7 are in the Appendix to this paper); and
- (b) includes an entity that is classified as a subsidiary in any relevant approved financial reporting standard.

Implications for local authorities

Section 5(2)(a): subsidiaries

304 Section 5(2)(a) should be read together with the definition of “LATE” in the LGA. Their combined effect is:

- Companies in which 50% or more shares are held by local authorities are “public entities” by virtue of the definition of LATE in the LGA (see Part 1 of this paper).
- Should a local authority hold less than 50% of shares in a company, but nonetheless control the composition of the board (for example, due to rights attached to its shares or under the constitution), the company will not be a LATE for the purposes of the LGA, but will nevertheless be a “public entity” for the purposes of the Public Audit Act.
- The Auditor-General will be the auditor of any subsidiary of a LATE, even if there is uncertainty as to whether the subsidiary is also a LATE.

- The Auditor-General will be the auditor of subsidiaries based overseas, if such subsidiaries are controlled in accordance with any approved financial reporting standard. This raises some practical issues for appointment of auditors.

Section 5(2)(b): GAAP

- 305 Section 5(2)(b) uses the term “relevant approved financial reporting standard”. Section 4 defines “approved financial reporting standard” as having the same meaning as in section 2(1) of the Financial Reporting Act 1993.
- 306 Section 5(2)(b) will cover an entity that is not a “subsidiary” of a public entity, if that entity is “controlled” by the public entity within the meaning of any “relevant approved financial reporting standard”.¹⁴
- 307 More significantly, section 5(2)(b) covers an entity which other public entities **together control** within the meaning of a relevant approved financial reporting standard.
- 308 ED-84¹⁵ makes it clear that the decision-making power that satisfies the power element of “control” must be a unilateral power. The power cannot be a divided or shared power that is exercised jointly by 2 or more co-owners or partners. Section 5(2)(b) addresses this by using the words “together control”. The intention is that the interests of public entities are to be amalgamated for the purpose of determining whether or not the Auditor-General is the auditor of a particular entity under section 5(2)(b).

Section 5(2)(c): composition of the governing body

- 309 Section 5(2)(c) provides that the Auditor-General will be the auditor of any entity where one or more public entities¹⁶ together control directly or indirectly the composition of the board of the entity, within the meaning of sections 7 and 8 of the Companies Act 1993.
- 310 Under those sections, control of the composition of the board exists where the controlling entity can appoint or remove all or a majority of the governing body.¹⁷
- 311 Section 5(2)(c) extends to the ability of public entities acting together **indirectly** to control the composition of the governing body of an entity. The issues about requirements for indirect control discussed in Part 1 of this paper may therefore arise. An example may be a trust settled by an association owned by a number of

¹⁴ As noted above, it is likely that a financial reporting standard based on ED-84 will be issued sometime during 2001 and this standard will be relevant.

¹⁵ Discussed in Part 2 of this paper.

¹⁶ Which could be local authorities, LATEs, or any other public entities as defined in the Act.

¹⁷ Compare the definition of “significant control” applying to LATEs – if local authorities can appoint **half** the governing body that is sufficient.

public entities, where the association has the right to appoint or remove a majority of trustees. The association would be a public entity under section 5(2)(b) or (c), being under the direct control of a number of public entities. While the trust would not be a “subsidiary” of the association, the public entities may together *indirectly* control the composition of the governing body of the trust (through direct control of the governing body of the association) and the trust would be a public entity under section 5(2)(c).

- 312 The control test will make the Auditor-General the auditor of any entity controlled by one or more LATEs, even if there is uncertainty as to whether the entity is also a LATE.

Concluding comment on the Public Audit Act

- 313 The scope of section 5 makes the Auditor-General the auditor of entities such as trusts that are controlled by one or more local authorities. Such entities will not necessarily be LATEs.
- 314 We will contact auditors and local authorities further about the impact of the control test in section 5 when the new Financial Reporting Standard is finalised.

Appendix

5. Meaning of "holding company" and "subsidiary"—

- (1) For the purposes of this Act, a company is a subsidiary of another company if, but only if,—
- (a) That other company—
 - (i) Controls the composition of the board of the company; or
 - (ii) Is in a position to exercise, or control the exercise of, more than one-half the maximum number of votes that can be exercised at a meeting of the company; or
 - (iii) Holds more than one-half of the issued shares of the company, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital; or
 - (iv) Is entitled to receive more than one-half of every dividend paid on shares issued by the company, other than shares that carry no right to participate beyond a specified amount in a distribution of either profits or capital; or
 - (b) The company is a subsidiary of a company that is that other company's subsidiary.
- (2) For the purposes of this Act, a company is another company's holding company, if, but only if, that other company is its subsidiary.

In sections 5, 7 and 8 of the Companies Act, the expression "company" includes a body corporate.

7. "Control" defined—

For the purposes of section 5 of this Act, without limiting the circumstances in which the composition of a company's board is to be taken to be controlled by another company, the composition of the board is to be taken to be so controlled if the other company, by exercising a power exercisable (whether with or without the consent or concurrence of any other person) by it, can appoint or remove all the directors of the company, or such number of directors as together hold a majority of the voting rights at meetings of the board of the company, and for this purpose, the other company is to be taken as having power to make such an appointment if—

- (a) A person cannot be appointed as a director of the company without the exercise by the other company of such a power in the person's favour; or
- (b) A person's appointment as a director of the company follows necessarily from the person being a director or other officer of the other company.